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No. 905

# In the Supreme Court of the United States

OCTOBER TERM, 1959

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

*v.*

LEA FABRICS, INC., ET AL.

*PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

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## JURISDICTION

The order of the Court of Appeals (App., *infra*, pp. 18–19), affirming the judgment of the district court, was entered on December 8, 1959, and a timely petition for rehearing was denied on January 5, 1960 (App., *infra*, p. 19). On March 31, 1960, Mr. Justice Brennan extended the time for filing a petition for a writ of certiorari to and including May 4, 1960. The order of the Court of Appeals denying the Commission's motion to vacate the judgment for mootness was entered on March 23, 1960 (App., *infra*, p. 20). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Whether the Court of Appeals should have vacated its prior judgment affirming an order of the district court, sustaining the propriety of proceeding under Chapter XI of the Bankruptcy Act, when the order of the district court had been rendered moot by an adjudication of bankruptcy.

## STATUTE INVOLVED

Chapters X and XI of the Bankruptcy Act, 52 Stat. 883 and 905, 66 Stat. 431 (11 U.S.C. 501, *et seq.* and 701, *et seq.*) are involved in this proceeding substantially in their entirety.

## STATEMENT

The debtor, Lea Fabrics, Inc., filed a petition for an arrangement under Chapter XI of the Bankruptcy Act on January 21, 1959. It has outstanding over 1,000,000 shares of $5 par value common stock held by approximately 1,000 persons. According to the debtor's schedules, as of March 3, 1959, its assets

were $1,620,500 and liabilities were $1,752,785. The assets consisted of plant, machinery and equipment, certain television properties and stock in other companies. All of these were mortgaged or pledged. The debtor had been in business for many years manufacturing automobile fabrics. Several years prior to the filing of the petition, however, its business was materially altered by a new management to the point where the debtor no longer engaged in manufacturing operations. Instead, it sold its inventory and, partly through the issuance of newly-authorized shares of stock and the mortgaging or pledging of its theretofore lien-free assets, the debtor acquired new assets, including motion picture and television rights (which subsequently were sold, pledged or transferred by the debtor in exchange for stock of a television film corporation) and three steamships (two of which were placed in a newly-formed subsidiary of the debtor and later exchanged for stock in a third corporation). Many of these transactions involved companies that were under common control with the debtor. These transactions resulted in over-all losses to the debtor (R. 16a–19a, 79a, 83a–84a).

The debtor's plan of arrangement provided for the payment in full of priority claims and administration expenses and for a twenty-percent payment to unsecured creditors in full satisfaction of their claims (R. 20a). This arrangement was accepted on March 24, 1959 (R. 20a); confirmation was postponed from time to time at the debtor's request, until September 23, 1959, in order to enable it to work out necessary

agreements with outside interests which would presumably permit the debtor's substantial operating losses to be utilized for federal income tax savings (R. 51a–56a, 57a–63a, 66a–69a, 70a–73a, 74a–76a). In the meantime, the realty and chattel mortgages on the debtor's property were foreclosed and sold. Shortly before September 23, 1959, the debtor had worked out a series of proposed transactions which included (1) the borrowing of the necessary cash for the Chapter XI arrangement from a company associated with the present management, which would receive debtor's notes or other evidences of indebtedness, (2) the debtor's recapitalization through issuance of new preferred stock and a reduction to one-fourth of the amount of common stock outstanding; (3) the acquisition of new assets with preferred and common stock thus made available, (4) the sale of these assets for cash, (5) with cash so obtained and with stock, the purchase of the assets of a partnership engaged in the financing business, (6) payment of most of the advances for the Chapter XI arrangement, and (7) the debtor's entry into the financing business (R. 20a–22a).

On September 23, 1959, the Securities and Exchange Commission, pursuant to Section 328 of Chapter XI, 11 U.S.C. 728, moved to intervene and to dismiss the Chapter XI proceeding unless the debtor's petition was amended to comply with the requirements of Chapter X (R. 8a–14a). In its motion and allied papers, the Commission contended that the Chapter XI proceeding should be dismissed because the arrangement was but a single step in a pervasive

reorganization, which those in control of the debtor were seeking to implement beyond the Chapter XI court's jurisdiction and for which the provisions of Chapter X were more appropriate (R. 10a, 13a, 20a–22a). The district court denied the Commission's motion (R. 35a–43a), and on appeal by the Commission the Court of Appeals affirmed (App., *infra*, pp. 13–19); it subsequently denied a petition for rehearing (App., *infra*, p. 19).

Pending review in the Court of Appeals the proceeding in the district court had been stayed. Thereafter, the debtor again sought adjournments in the district court; but, on February 17, 1960, the debtor was unable to provide a $5,000 indemnity required by the district court as a condition for a further adjournment pursuant to Section 326 of Chapter XI, 11 U.S.C. 726. On February 18 (after denial of rehearing by the Court of Appeals), the district court, having found that payment of such indemnity was not forthcoming and that "the possibilities of the debtor raising the money to effectuate its proposed plan of arrangement did not seem possible or probable at this time," adjudicated the debtor a bankrupt pursuant to Section 327 of the Bankruptcy Act, 11 U.S.C. 727, and ordered that bankruptcy be proceeded with.

Thereupon, the Commission moved that the Court of Appeals vacate its judgment of December 8, 1959, recall its mandate to the district court, if deemed necessary, and remand to the district court with directions to that court to vacate as moot its order refusing to dismiss the debtor's petition under Chapter XI.

This motion was denied, without opinion, by the Court of Appeals on March 23, 1960 (App., *infra*, p. 20).

## REASONS FOR GRANTING THE WRIT

Upon the debtor's adjudication as a bankrupt prior to the expiration of the statutory period for judicial review,[2] the decision of the Court of Appeals upholding the propriety of the debtor's resort to Chapter XI, as against Chapter X, of the Bankruptcy Act was rendered moot and the debtor's proposed Chapter XI arrangement became a nullity.

Under similar circumstances this Court in the past has granted certiorari to reverse or vacate a judgment below and has remanded with directions to dismiss the action. For example, in *Federal Power Commission* v. *Midwestern Gas Transmission Company*, 358 U.S. 280, the decision of the court of appeals was vacated on the ground of mootness, since the issue involved (the necessity for consolidation of hearings before the Power Commission) had become moot by reason of an amendment to the application of one of the companies seeking consolidation prior to the expiration of the time for filing a petition for

[2] The debtor was adjudicated a bankrupt on February 18, 1960. The date of the denial of the petition for rehearing by the Court of Appeals, January 5, 1960, started the running of the ninety-day period during which a petition for a writ of certiorari could be filed and, accordingly, that period would not expire until April 4, 1960. 28 U.S.C. 2101(c), *Pfister* v. *Northern Illinois Finance Corp.*, 317 U.S. 144, 149–150. That period has since been extended. See p. 2, *supra*.

a writ of certiorari in this Court. And see *Brownlow v. Schwartz*, 261 U.S. 216, where this Court reversed and vacated the judgment of the court of appeals since its determination as to the propriety of a refusal to issue a building permit had been rendered moot by virtue of the issuance of the permit subsequent to the decision of the court of appeals but prior to the filing of a writ of error. Similarly, in *American Public Power Association* v. *Power Authority*, 355 U.S. 64, this Court vacated the decision of the court below where the question of the power of the Federal Power Commission to issue a license to the New York Power Authority was rendered moot by virtue of the enactment by Congress of legislation authorizing and directing issuance of the license during the period provided by statute for filing a petition for a writ of certiorari. See also, for example, *United States* v. *Alaska Steamship Co.*, 253 U.S. 113; *Leader* v. *Apex Hosiery Co.*, 302 U.S. 656; *Sawyer* v. *Dollar*, 344 U.S. 806; *Garcia* v. *Lanton*, 348 U.S. 856; and *McKay* v. *Clackamas County*, 349 U.S. 909. Cf. *First Union Trust & Savings Bank* v. *Consumers Company*, 290 U.S. 585, where the issue of the propriety of the district court's granting an injunction against foreclosure upon certain property was rendered moot pending appeal to the Court of Appeals because the district court had lost jurisdiction over the property as a result of the debtor's subsequent adjudication as a bankrupt; this Court reversed the

affirmance by the Court of Appeals with directions that the injunction order be vacated.

These decisions are consistent with a long established policy respecting intervening mootness. As this Court has stated: "Where it appears upon appeal that the controversy has become entirely moot, it is the duty of the appellate court to set aside the decree below and to remand the cause with directions to dismiss." *Duke Power Company* v. *Greenwood County,* 299 U.S. 259. Thus, to prevent abstract determinations from governing results of subsequent cases, this Court has reversed and vacated a lower court judgment, whether or not there are plausible grounds for predicting that the issue rendered moot might become justiciable in the future. See *United States* v. *Hamberg-American Company,* 239 U.S. 466, 475; *Commercial Cable Company* v. *Burleson,* 250 U.S. 360; *Leader* v. *Apex Hosiery Co.,* 302 U.S. 656, *supra.* The vacation of the judgment of the lower court where the case has become moot during the course of appellate review will "prevent a judgment, unreviewable because of mootness, from spawning any legal consequences." *United States* v. *Munsingwear,* 340 U.S. 36, 41. It does not deprive the parties of whatever rights might accrue to them in the future; on the contrary, it "* * * clears the path for future relitigation of the issues between the parties and eliminates a judgment, review of which was pre-

vented through happenstance." *Id.* at 40.[3] In that case the failure of the plaintiff to move for vacation of the district court's order on the ground of mootness was held to preclude it from challenging the holding in a subsequent proceeding between the parties.

In the present case, the determination of the court below, if not vacated, may well affect the result of other cases under Chapter XI of the Bankruptcy Act. The Commission argued in both lower courts that the proposed arrangement under Chapter XI was improper in view of the necessity for a pervasive reorganization of the debtor involving both a material readjustment of its capital structure and its entering into a new field of business. This latter step was necessary because all assets of consequence, except a tax loss carry-forward, had been lost through foreclosure.

The debtor intended to effectuate these necessary steps outside the jurisdiction of the district court by private unsupervised arrangements, thus accomplishing a reorganization in part by an arrangement in

[3] See Scott, *Collateral Estoppel by Judgment*, 56 Harv. L. Rev. 1, 16 (1942): "In situations * * * where the controversy has become moot before the appellate court has made its decision, it would seem that the better practice is not merely to dismiss the appeal, but to dismiss the suit or to direct the lower court to do so. The result then clearly is that the matter will not be *res judicata*, since there is no judgment on the merits."

court under Chapter XI and in part by corporate action out of court. The Commission argued that this was comparable to the dual-phased plan of reorganization proposed in *Securities and Exchange Commission* v. *United States Realty & Improvement Company*, 310 U.S. 434, where this Court held it reversible error to resort to Chapter XI instead of Chapter X. Cf. *General Stores Corporation* v. *Shlensky*, 350 U.S. 462. The Commission also contended that, if rehabilitation could be accomplished at all within the framework of the Bankruptcy Act, resort should have been had to Chapter X because of its broader remedial scope and greater protective features and the needs to be served.

Had the case not become moot, the correctness of the ruling of the court of appeals could have been submitted to this Court for review. However, the intervening bankruptcy of the debtor has made the order sustaining Chapter XI proceedings moot so that review of the merits here is now precluded. Nevertheless, the court below has refused to vacate its judgment approving the order, so that that judgment now stands as a precedent for what the Commission believes to be an erroneous use of Chapter XI as against Chapter X of the Bankruptcy Act.[4]

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[4] It is possible that prior to the conclusion of the pending bankruptcy proceedings a new petition for an arrangement under Chapter XI may be filed, since, under Section 321 of that chapter, 11 U.S.C. 721, such a petition may be filed "either before or after * * * adjudication." If this happened while the court of appeals judgment remains outstanding, it might be urged that, under the doctrine of the *Munsingwear* case, the Commission would be precluded from contesting the use of Chapter XI by this debtor.

## CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted, the judgment of the court below should be vacated and the cause should be remanded to the district court with directions that it vacate its order denying petitioner's motion to dismiss the Chapter XI proceeding.

Respectfully submitted.

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MAY 1960.

# APPENDIX

## United States Court of Appeals for the Third Circuit

No. 13054

IN THE MATTER OF LEA FABRICS, INC., DEBTOR

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

*APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY*

Argued November 17, 1959

Before BIGGS, *Chief Judge,* and GOODRICH and McLAUGHLIN, *Circuit Judges*

*Opinion of the Court*

(Filed December 8, 1959)

By GOODRICH, *Circuit Judge.*

This is an appeal from a judgment of the District Court for New Jersey denying a motion of the Securities and Exchange Commission to dismiss a Chapter XI bankruptcy proceeding unless the petition therein be amended to comply with the requirements of Chapter X. The district judge filed no written opinion but this Court has had the benefit of reading his oral opinion issued prior to the order denying the motion. The Securities and Exchange Commission takes this appeal.

The debtor, Lea Fabrics, Inc., formerly manufactured "a special and unique type of carpeting de-

signed and fabricated to serve the automobile trade." This business fell off and became a losing venture. The corporation then interested itself in various other enterprises the nature of which is not necessary to detail here. Its real and movable property was mortgaged and those mortgages have been foreclosed, the foreclosures resulting in the creation of deficiencies. The debtor is insolvent. On November 10, 1958, on petition of a creditor, a statutory receiver was appointed by the Chancery Division of the Superior Court of New Jersey, Essex County. This receivership continued for about two months and was terminated when the debtor filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. 11 U.S.C.A. §§ 701–99. The receiver appointed in the Chapter XI proceeding was the same person who had served as receiver in the prior state court proceedings.

After several months an arrangement was proposed and agreed to by the necessary majority of the creditors. Under this arrangement the unsecured creditors are to receive twenty cents on the dollar. There is to be a sufficient fund ($300,000) to be available for this purpose obtained by management on an unsecured loan. This fund will pay the expenses of administration in full, the priority claims in full and the general creditors twenty cents on the dollar as indicated. After the plan was proposed the settlement of the matter was delayed from time to time while management sought to find the money necessary to consummate the arrangement. At the hearing where confirmation was to be sought the Securities and Exchange Commission intervened[1] and made its motion

[1] SEC intervention was predicated on Section 328 of the Bankruptcy Act, added in 1952, 11 U.S.C.A. § 728 (Supp. 1958), which in pertinent part reads as follows:

"§ 728. Dismissal, proceedings; amended petition

"The judge may, upon application of the Securities and Ex-

to dismiss the Chapter XI proceeding unless the debtor would amend so as to come in under Chapter X. This the debtor refused to do.

All of the decisions to which we have been referred, five in number, dealing with the problem of whether to dismiss Chapter XI proceedings unless the debtor brings itself under Chapter X place great emphasis upon the discretion vested in the trial judge on this question. The cases are as follows: *SEC v. United States Realty Co.*, 310 U.S. 434 (1940); *In re Transvision, Inc.*, 217 F. 2d 243 (2d Cir. 1954), *cert. denied* 348 U.S. 952 (1955); *General Stores Corp.* v. *Shlensky*, 350 U.S. 462 (1956); *SEC* v. *Wilcox-Gay Corp.*, 231 F. 2d 859 (6th Cir. 1956); *SEC* v. *Liberty Baking Corp.*, 240 F. 2d 511 (2d Cir.), *cert. denied* 353 U.S. 930 (1957).[2]

That discretion, it is to be observed, is not one limited greatly by settled legal rules. True, it has been categorically stated that Chapter XI is not solely for small corporations and Chapter X not solely for big corporations. *General Stores Corp.* v. *Shlensky*, 350

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change Commission * * * if he finds that the proceedings should have been brought under chapter 10 of this title, enter an order dismissing the proceedings under this chapter, unless, within such time as the judge shall fix, the petition be amended to comply with the requirement of chapter 10 of this title for the filing of a debtor's petition or a creditors' petition under such chapter, be filed * * *."

[2] For a review of the uncertain legislative history and the cases prior to the Supreme Court's affirmance in *General Stores*, the Sixth Circuit's affirmance in *Wilcox-Gay* and the Second Circuit's reversal in *Liberty Baking*, see: Weintraub, Levin & Novick, *Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 24 Fordham L. Rev. 616 (1956).

For the story thereafter see: Weintraub & Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 26 Fordham L. Rev. 292 (1957).

U.S. 462, 465–66 (1956). But the criterion by which the district judge's discretion is to be exercised has to do with the best arrangement for all parties concerned under the circumstances confronting the particular corporation. *Ibid.*

The discretion was properly exercised in this instance. The debtor's corporate structure is a simple one; it has common shareholders but no preferred shareholders or bondholders. Management owns or controls more than half the common stock. The proposed arrangement does not interfere in any way with whatever rights shareholders may have. The plan has been agreed to by the unsecured creditors and the priority creditors, including tax claimants, are fully cared for.

Not the least of the considerations which prompt approval of the trial judge's exercise of discretion is the situation of this corporation. It was engaged, apparently profitably, in the manufacture of goods no longer in market demand. Its other ventures have been unsuccessful. It has no tangible assets except some television properties the value of which is speculative. According to the record, all the corporation now has of any substantial value is a tax loss carry-over.

Chapter X proceedings would involve the appointment of a disinterested trustee and investigation into the previous operation of this corporation before a plan for rehabilitation could be submitted, if indeed such a plan ever could be worked out. All of this necessarily involves time and money. There is $33,000 under the control of the referee which he insisted on being deposited as a condition to granting continuances while funds were being sought to effect the plan. The Securities and Exchange Commission says that "presumably" this $33,000 would be avail-

able for Chapter X expenses. We do not see the basis on which the presumption rests, nor are we advised how far the $33,000 would go in providing for the expenses of such investigation and report as a trustee might make. The $300,000 to be used to pay creditors, as we understand it, is not yet cash in hand but will be upon approval of the Chapter XI plan if it is not too long delayed.

There is, in this case, a situation where, as Judge Medina said in the *Transvision* case, "there may be some basis for suspecting possible improprieties in past management." 217 F. 2d at 247. What we say here is by no means to be interpreted as giving past management of Lea Fabrics a health certificate. The point is that we do not know whether there is basis for anything more than "possible improprieties." If there is, the arrangement here does not deprive any shareholder of his rights to enforce claims for losses occasioned by improper management. To further quote from Judge Medina's opinion:

> Certainly, so ephemeral a suspicion is not an adequate basis upon which to overturn a plan which the District Court, on the facts before it at this time, appears to believe may ultimately be found feasible, and one which, necessarily, would have to be acceptable to at least a majority of the unsecured creditors before being approved. *Ibid.*

While the New Jersey receivership was in progress the receiver made a seven-day investigation of the debtor's relations with certain other companies in which management was also interested. There was not, at the time, even enough money to have the testimony transcribed. The investigation developed noth-

ing of value. It was admittedly a nonthorough one but in a week's hearing it should have produced at least some clues if clues were to be found.

The court here was confronted with the expensive possibility of an investigation to determine whether vague suspicions were well founded. The debtor has no assets with which to finance such an investigation. Even if a plan evolved under Chapter X which was "fair and equitable," 11 U.S.C.A. § 621(2), the shareholders would stand little chance of profiting by it. We think that the district court exercised sound business, as well as legal, judgment in denying the motion to dismiss the Chapter XI proceeding.

The judgment of the district court is affirmed.

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United States Court of Appeals for the Third Circuit

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No. 13054

IN THE MATTER OF LEA FABRICS, INC., DEBTOR

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

---

*ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY*

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Present: BIGGS, *Chief Judge,* and GOODRICH and MCLAUGHLIN, *Circuit Judges.*

*Judgment*

This cause came on to be heard on the record from the United States District Court for the District of New Jersey and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the

said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF, *Clerk.*

DECEMBER 8, 1959.

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United States Court of Appeals for the Third Circuit

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No. 13054

IN THE MATTER OF LEA FABRICS, INC., DEBTOR

SECURITY AND EXCHANGE COMMISSION, APPELLANT

---

*SUR PETITION FOR REHEARING*

---

Present: BIGGS, *Chief Judge,* and GOODRICH, MCLAUGHLIN and FORMAN, *Circuit Judges.*

After due consideration the petition for rehearing in the above-entitled case is hereby denied.

By the Court:

GOODRICH,
*Circuit Judge.*

Dated: January 5, 1960.

United States Court of Appeals for the Third Circuit

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No. 13054

IN THE MATTER OF LEA FABRICS, INC., DEBTOR

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

---

Present: BIGGS, *Chief Judge*, and GOODRICH and MCLAUGHLIN, *Circuit Judges*.

Upon consideration of the motion by Securities and Exchange Commission to vacate the opinion and judgment in the above case for mootness;

*It is ordered*, That the motion be, and it is hereby denied.

By the Court:

GOODRICH,
*Circuit Judge*.

MARCH 23, 1960.

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